Final Insurance Europe position on the VA risk correction

Introduction

Insurance Europe welcomes the EC's proposals on the volatility adjustment (VA) with the exception of its stated intention to adopt EIOPA's recommendation to change the risk correction to be a percentage of the prevailing credit spread.

The aim of the risk correction is to adjust for the possibility that insurers are not able to earn the spreads based on defaults of the counterparties embedded in the reference portfolio. The calculation of the VA is based on a normal environment and should be assessed as such.

EIOPA's proposed changes to the risk correction could undermine the beneficial impact of other improvements and would diminish the anticyclical qualities of the VA. Insurance Europe analysis shows that EIOPA's proposed change to the risk correction would have made it up to 40% less effective in previous crisis situations.

Insurance Europe strongly supports the retention of the current risk correction methodology.

There is evidence that the existing risk correction, is based on sound economic principles, is already calibrated conservatively, and has worked well in ensuring the impact of defaults and downgrade is adequately covered. Evidence justifying a change has not been put forward.

- The risk correction should reflect the expected cost of default and downgrade ie a realistic assessment of the long-term costs incurred by holding a diversified portfolio of bonds over the long-term. As such, this should be based on historical average default statistics.

- The current methodology to derive the risk corrections already contains a margin for prudence relative to the true expected default costs for corporate bonds due to the long-term average spread underpin (see charts below).

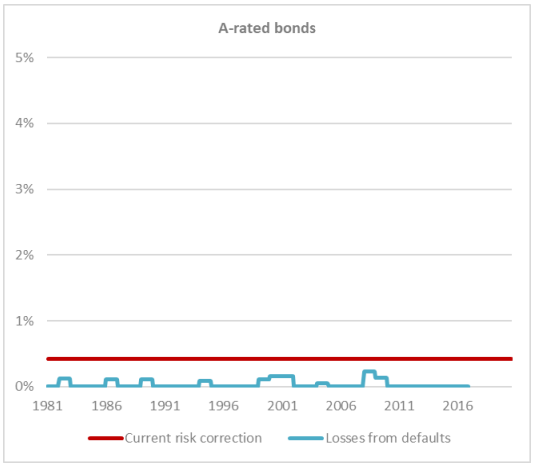

Chart 1a

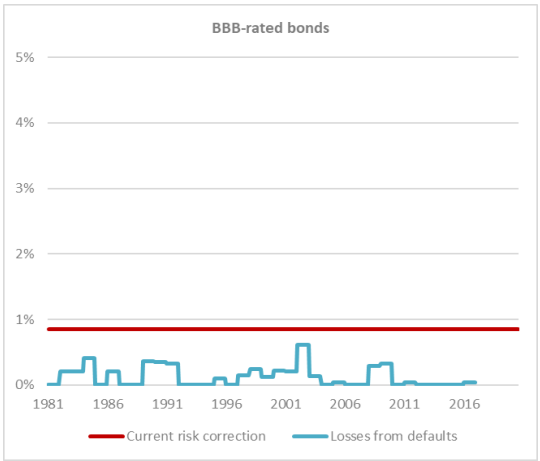

Chart 1b

If EIOPA's flawed approach is taken forward by policymakers, its calibration must be improved to avoid increasing procyclicality and to avoid undermining the purpose and effectiveness of the Volatility Adjustment mechanism.

EIOPA's proposals to change the risk correction to be a percentage of the prevailing spread would undermine the improvements to the VA proposed by the EC during periods of very high market volatility and exacerbate procyclicality. These are exactly the situations when the VA is most important.

In order to minimise the adverse effects introduced by EIOPA's proposal and to maintain the VA's ability to act as an effective countercyclical tool, the risk correction proposed by EIOPA should be amended by:

- Gradually reducing the impact of the risk correction on the level of the VA when credit spreads widen significantly. In its proposal, EIOPA already reduces the impact of the risk correction when spreads are higher than their long-term average. However, further mitigation is necessary to ensure the anticyclical qualities of the VA. This can be achieved by defining an additional layer for the portion of the current spreads that exceed twice their respective long-term averages.

- Reducing the percentages in case the spread values exceed their long-term average (LTAS);

The resulting proposed formula for the RC would have the following form both for the government and corporate component:

$$RC = \alpha\% * \min(S^+, LTAS^+) + \beta\% * \max[0, \min(S^+ - LTAS^+, LTAS^+)] + \gamma\% * \max(0, S^+ - 2 * LTAS^+)$$

The parameters α, β, γ are defined as follows:

RC for government bonds issued by EEA countries	RC for other fixed income assets
$\alpha_{gov}\% = 30\%$	$\alpha_{corp}\% = 50\%$
$\beta_{gov}\% = 15\%$	$\beta_{corp}\% = 25\%$
$\gamma_{gov}\% = 7.5\%$	$\gamma_{corp}\% = 12.5\%$

In its advice, EIOPA's justification for the 50% and 30% parameters were based on flawed analysis of default risk. The alternative calibration of EIOPA's risk correction noted above, and supported by the industry, solely aims to reduce the additional procyclicality introduced by this proposal. The alpha, beta and gamma factors have been chosen to achieve this objective.

Backtesting shows that this change to EIOPA's approach will mitigate some of the additional procyclicality of the change

The charts below show simulations of the Euro VA and the impact of the volatility of changes in own funds on the SCR ratio of a simplified, hypothetical company over the market conditions of the past 15 years.

In Chart 2, the black dashed line represents the spread of the Euro reference portfolio and shows its volatility. The coloured lines show the extent to which the different calibrations of the VA would have mitigated this volatility.

- Blue line: Euro VA with EIOPA's proposed risk correction
- Orange line: Euro VA with existing risk correction
- Yellow line: Euro VA with improved EIOPA risk correction methodology

Chart 3 shows the impact of Own Funds volatility on the SCR ratio of a simplified, hypothetical insurance company arising from changes in spreads. Note that the impact analysis on the SCR ratio only shows the impact of changes in own funds. The SCR is assumed to be constant.

It is clear that the blue line of Chart 2 is the least effective of the three in mitigating volatility in crisis periods. The improvements outlined above (shown in the yellow line) would substantially increase its effectiveness in crisis periods.

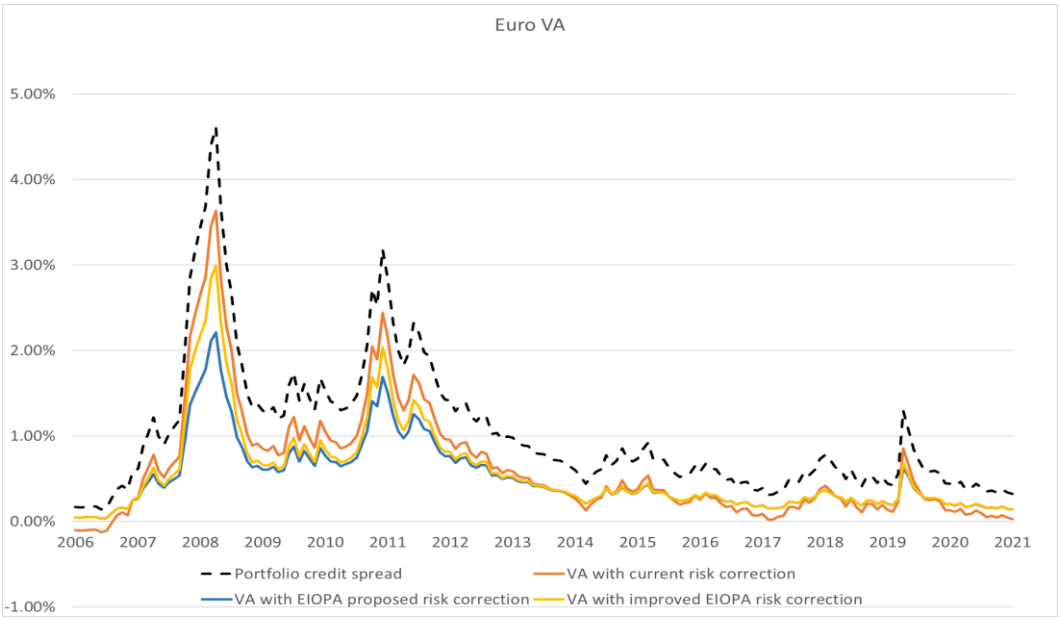

Chart 2

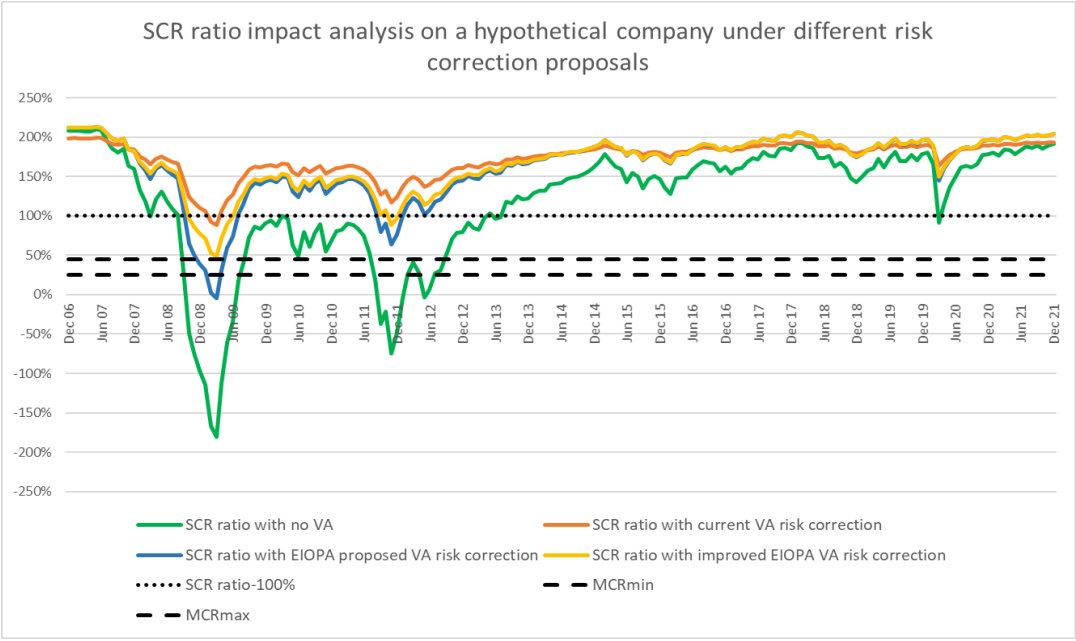

Chart 3

Source: Refinitiv/Secretariat calculations.

Main assumptions:
VA calculations assume 85% GAR, 100% CSSR and use YE2021 reference portfolio.
Hypothetical company invests only in EUR reference portfolio fixed income assets.
Assets and liabilities are duration matched.